

## Message Text

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ACTION EB-04

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TREASURY DEPT WASHDC

C O N F I D E N T I A L SECTION 01 OF 03 LONDON 13856

LIMDIS GREENBACK

TREASURY PASS UNDER SECRETARY SOLOMON

E.O. 11652: XGDS-1

TAGS: UK, EFIN

SUBJECT: HMTREASURY AND BANK OF ENGLAND VIEWS ON  
EMS AND IMF

SUMMARY: FROM UK POINT OF VIEW, OFFICIALS INVOLVED IN  
EMS DELIBERATIONS IDENTIFY THREE NECESSARY LEVELS OF  
ACTIVITY: EC TECHNICAL DISCUSSIONS AND IDENTIFICATION  
OF OPTIONS STEMMING FROM BREMEN PROPOSALS; INTERNAL HMG  
STUDIES ON COST AND IMPACT OF OPTIONS ON UK ECONOMY;  
POLITICAL LEVEL DIRECTION AND DECISIONS, WHERE VERY  
LITTLE MOVEMENT IS EXPECTED IN UK UNTIL AFTER EXPECTED  
OCTOBER ELECTIONS. SENIOR HMT OFFICIAL HOPES U.S.  
SPEECHES AT IMF WILL ATTEMPT INJECT SOME U.S. LEADER-  
SHIP INTO THE INTERNATIONAL MONETARY SYSTEM. END SUMMARY

1. DURING PAST WEEK, TREASURY REP HAS HAD DISCUSSIONS  
WITH HALF DOZEN HMTREASURY AND BANK OF ENGLAND OFFICIALS  
RESPONSIBLE FOR VARYING ASPECTS OF ONGOING WORK ON EMS,  
INCLUDING KEN COUZENS, SECOND PERMANENT SECRETARY,  
HMTREASURY. THESE OFFICIALS IDENTIFY AT LEAST THREE  
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LEVELS OF ACTIVITY: THE FIRST COMPRISES THE TECHNICAL  
OPTIONS OF THE BREMEN PROPOSALS BEING DISCUSSED IN EC  
MONETARY AND CENTRAL BANK COMMITTEES; THE SECOND IS  
THE INTERNAL SERIES OF STUDIES BEING MADE BY HMTREASURY  
ANDBANK OF ENGALND ON COSTS AND BENEFITS OF ESTABLISHING  
EMS TO UK AND OTHER EC MEMBERS; THE THIRD IS THE  
DIMENSION THAT ENCOMPASSES TIMING AND POLITICAL DECISION

MAKING.

2. TECHNICAL DISCUSSIONS IN THE EC:

A. AN OFFICIAL WHO ATTENDED THE EC MONETARY COMMITTEE ALTERNATES SESSION AUGUST 10-11 REPORTS DISCUSSION OF OPTIONS CONTINUED ON THE MAIN TOPICS IDENTIFIED IN LONDON 12678 ,I.E., THE CHARACTER OF THE NUMERAIRE, METHODS OF INTERVENTION AND PROVISION OF CREDIT. SOURCE SAID UK IS PARTICIPATING FULLY, IN GOOD SPIRIT, IT'S A FASCINATING INTELLECTUAL EXERCISE, AND GOOD PROGRESS IS BEING MADE IN IDENTIFICATION OF OPTIONS. NO HARSH EXCHANGES THUS FAR. ONLY THE FRENCH APPEAR GENUINELY ENTHUSIASTIC, AND THEY MAY HAVE BEEN INSTRUCT-ED TO BE SO. DIFFERENCES OF OPINION CONTINUE ON THE NUMERAIRE, "THE GERMANS TENACIOUS AS TERRIERS" IN ARGUING FOR THEIR GRID OR SNAKE SYSTEM, OTHERS INCLUDING THE UK FAVORING A WEIGHTED SYSTEM THAT WOULD MORE READILY IDENTIFY "THE DEVIANT CURRENCY". ON STRICTNESS AND RIGIDITY OF THE FUTURE SYSTEM, THE LINE-UP FROM RIGHT TO LEFT APPEARS TO BE THE BENELUX MEMBERS OF THE SNAKE, GERMANY, FRANCE, THE U.K., AND ITALY.

B. SOURCE SAID MEETING GOT INTO SOMETHING OF A MUDDLE DURING DISCUSSION OF CREDIT FACILITIES AND CREA-TION OF ECU; IT WAS FAIRLY CONFUSED. SOME DELEGATES CONTINUE TO POINT OUT CREATION OF NEW FUNDS AND LEGAL ENTITIES COULD PROBABLY BE DISPENSED WITH THROUGH CONFIDENTIAL

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BETTER USE OF CENTRAL BANK NETWORK. IT IS BEING MADE CLEAR TO THE GERMAN DELEGATES THAT THEY ARE GOING TO HAVE TO PAY("AND HOW") FOR A LESS FLEXIBLE SYSTEM AND THAT A DEGREE OF SYMMETRY IS EXPECTED. BANK OF ENGLAND OFFICIAL JUDGED IF A LESS FLEXIBLE SYSTEM IS ADOPTED WITHOUT MASSIVE CREDIT AVAILABLE TO SUPPORT WEAKER CURRENCIES, "IT WILL BE A SPECULATOR'S DREAM".

3. THE DOMESTIC COSTS:

A. A BANK OF ENGLAND/HMTREASURY WORKING GROUP, UTILIZING SENIOR ECONOMISTS AND DOMESTIC FORECASTERS FROM EACH INSTITUTION, IS MEETING UNDER KEN COUZENS TO ASSESS THE COSTS AND POTENTIAL BENEFITS TO THE U.K., AND TO OTHER MEMBERS. WORK IS JUST GEARING UP AFTER VACATION PERIOD, GROUP HELD ITS FIRST SESSION LAST THURSDAY (8-24). ON ASSUMPTION THAT THE UK ENTERS AN EMS OF SOME TYPE, WITH GREATER FIXITY OF ORDINARY RATES AND NATIONAL INFLATION RATES HEADING DOWNWARDS TOWARDS LOWEST EC LEVELS, RATHER THAN TOWARDS AN AVERAGE OF EXISTING EC LEVELS, OFFICIALS CONSIDER THE OUTLOOK IN

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LIMDIS GREENBACK

THE FIRST 2-3 YEARS AT LEAST MUST BE SLOWER GROWTH, REDUCED INFLATION, GREATER UNEMPLOYMENT, (THERE ARE DIFFERING VIEWS ON THE DEGREE, BUT NOT THE BASIC SCENARIO) AND ON THE ASSUMPTION THAT UK WOULD GO IN AT A HIGHER THAN JUSTIFIED EXCHANGE RATE, A WORSE BALANCE OF PAYMENTS THAN WOULD OTHERWISE BE THE CASE AND AN INABILITY IN THE SHORT RUN TO IMPROVE COMPETITIVE POSITION BY ADJUSTING THE EXCHANGE RATE. THIS LEADS SOME OFFICIALS TO EXPRESS CONCERN ON PERSONAL BASIS FOR THE CURRENT LEVEL OF THE POUND WHICH IS SEEN AS HIGHER THAN JUSTIFIED BY UNDERLYING FUNDAMENTALS. THEY WOULD HOPE RATE COULD BE BROUGHT DOWN GENTLY OVER COMING MONTHS, BUT APPEAR NERVOUS AT THE PROSPECT, SHOULD MARKET CONSIDER DECLINE TO BE A POLICY AIM.

B. THESE OFFICIALS, INCLUDING COUZENS, WOULD LIKE TO BREAK THE DEVALUATION-INCREASED INFLATION-DEVALUATION LINK, AND SPECULATE THAT IF MINISTERS ARE BECOMING MORE CONCERNED WITH INFLATION, THEY MIGHT BE WILLING TO ACCEPT THE TRADEOFFS IMPLIED, PROVIDED UK'S EC PARTNERS PAY A SUFFICIENTLY HIGH PRICE ELSEWHERE, I.E., CHANGING BALANCE OF RESOURCE TRANSFER IN FEOGA, SOCIAL FUND AND REGIONAL POLICY.  
AT STAFF LEVEL, SOME OFFICIALS THINK AN EC INDUSTRIAL  
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FUND NEEDS TO BE SET UP TO ASSIST UK TO ADJUST TO THE NEW SYSTEM. (CHANCELLOR HEALEY REPEATED THIS GENERAL POINT IN PUBLIC COMMENTS IN EDINBURGH ON 8-25; "AS I AM ARGUING WITH MY COLLEAGUES IN THE EUROPEAN COMMUNITY, A CURRENCY UNION, STILL MORE AN ECONOMIC UNION, MUST REQUIRE STEADY FLOW OF RESOURCES FROM THE WEALTHIER PARTS OF THE UNION TO THOSE WHICH ARE LESS WEALTHY")

4. PRIVATE SECTOR (CITY) FINANCIAL VIEWS ON EMS:

NOT TOO MUCH DETAILED THOUGHT HAS BEEN GIVEN TO THE IMPACT OF EVENTUAL EMS, BECAUSE IT IS STILL TOO VAGUELY DEFINED. FINANCIAL COMMUNITY VIEWS GENERALLY RANGE FROM SKEPTICISM TO CYNICISM --"IF THE POLITICIANS PROPOSE IT, HOW CAN IT WORK?" TO THE EXTENT EMS IMPOSED GREATER ECONOMIC/FINANCIAL DISCIPLINE AND MADE GREATER EC RESOURCES AVAILABLE TO THE UK, IT WOULD BE WELCOME. TO THE EXTENT IT PLACED COUNTRIES WITH DISPARATE ECONOMIES AND INADEQUATE CREDIT FACILITIES INTO A SNAKE ("WE KNOW HOW THAT WORKS") OR A WEIGHTED BASKET ("WE'D HAVE TO LEARN HOW TO DEAL WITH IT") THE EXPECTATION WOULD BE FOR MORE CERTAIN PROFITS FROM ARBITRAGE AND SPECULATION AS WEAKER CURRENCIES EVENTUALLY WERE FORCED OUT, OR FORCED TO DEVALUE.

5. TIMING AND THE POLITICAL DIMENSIONS:

A. ABOVE PARAS REPRESENT DISTILLATION FROM MANY SOURCES. WHAT FOLLOWS, UNLESS NOTED, REPORTS ADDITIONAL POINTS MADE BY COUZENS DURING HOUR LONG SESSION ON 8-25. BANK OF ENGLAND SOURCES STRESSED THAT BANK OF ENGLAND DOES NOT HAVE A FORMAL POSITION ON EMS, BUT THOUGHT GOVERNOR OF BANK OF ENGLAND RICHARDSON, REMEMBERING 1976 DEBACLE, MIGHT OPT FOR GREATER DEGREE OF FIXITY THAN

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WOULD POLITICAL MINISTERS. HMTREASURY OFFICIAL WHO ATTENDS EC MONETARY COMMITTEE SESSIONS SAID UK BASIC POSITION REMAINS ONE OF "CONSTRUCTIVE CAUTION".

B. COUZENS NOTED UK IS IN RUNUP TO AN ELECTION; BOTH POLITICAL PARTIES ARE BEING VERY CIRCUMSPECT IN DEFINING THEIR POSITIONS ON EMS. COUZENS DID NOT THINK EC FINANCE COUNCIL SESSION ON SEPTEMBER 18 WOULD DECIDE ANYTHING. IT WILL REVIEW OPTIONS WITHOUT MAKING DECISIONS. IF AN ELECTION IS CALLED, UK MINISTERS' ATTENTION WILL BE ELSEWHERE; IF ELECTION IS NOT CALLED, THIS COULD RESULT IN FURTHER DELAY IN TAKING DECISIONS. COUZENS WILL MISS EC FINANCE COUNCIL, INSTEAD WILL GO TO MONTREAL ON SEPTEMBER 18 FOR COMMONWEALTH FINANCE MINISTERS SESSION. IT REMAINS TO BE SEEN IF HEALEY

WILL MAKE MONTREAL; HIS STAY IN WASHINGTON WILL BE ABBREVIATED.

C. ASKED IF HMTREASURY, AS DISTINCT FROM MINISTERS, HAS A POSITION ON EMS, COUZENS SAID EMPHATICALLY, "NO: THE UK SYSTEM DOES NOT WORK THAT WAY." ALTHOUGH CAREER OFFICIALS MIGHT HAVE SOME INFLUENCE, ON A TOPIC OF THIS IMPORTANCE, MINISTERS WOULD DECIDE. THE TECHNICAL WORK OF THE EC MONETARY COMMITTEE PROBABLY WOULD NOT BE VERY IMPORTANT TO THE OUTCOME. COUZENS EXPECTED THE FINAL SIX WEEKS OF THIS YEAR, FROM MID-OCTOBER, WOULD SEE INTENSE DIPLOMATIC/POLITICAL CONSULTATION AT HIGHEST LEVELS THAT WOULD DETERMINE THE SHAPE OF WHATEVER COMPROMISE SOLUTION COULD BE AGREED UPON. ASKED IF THERE WERE NOT A DANGER TO ITS INFLUENCE IF THE UK DID NOT PARTICIPATE IN A NEW SYSTEM,

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LIMDIS GREENBACK

COUZENS SAID SCHMIDT HAD ALREADY RAISED THE POSSIBILITY OF A TWO TIER SYSTEM. GIVEN RELATIVE NATIONAL STRENGTHS, COUZENS WONDERED IF THE UK COULD EXERT ANY MORE INFLUENCE IN THE SYSTEM THAN OUT OF IT, BUT STRESSED THAT IT WOULD BE A MINISTERIAL ASSESSMENT OF THE TRADEOFFS IDENTIFIED IN PARA 3 ABOVE THAT WOULD DETERMINE THE UK DECISION.

6. IMF MEETING:

A. COUZENS CITED PRESS REPORTS THAT U.S. MIGHT DRAW ON ITS CREDIT TRANCHE AT IMF. THE IDEA PLEASED HIM. HE HOPED PRESIDENT CARTER WOULD USE THE IMF

SESSION TO REASSERT SOME U.S. LEADERSHIP BY USING HIS SPEECH TO ANNOUNCE A PACKAGE ("WHICH HAS MORE OF AN IMPACT ON MARKETS THAN SELECTIVE ANNOUNCEMENTS") AND REINFORCE WHAT ALREADY HAS BEEN ANNOUNCED. WITH SOME POSSIBLE SELF-INTEREST SHOWING THROUGH, COUZENS SUGGESTED A U.S. PACKAGE THAT WOULD:

- DRAW ON THE IMF, REQUIRING A GAB INCREASE IN RESOURCES FROM SURPLUS COUNTRIES,
- SUPPORT FOR AN SDR ISSUE, AGREEING TO THE SUBSTITUTION ACCOUNT AND USING U.S. GOLD AT MARKET PRICES TO BUY THE U.S. SDR ("GETTING THE FRENCH

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AT ONE GO"),

- SUPPORT FOR A 45-50 PERCENT INCREASE DURING THE 7TH QUOTA REVIEW, EITHER PROPORTIONAL OR EQUI-PROPORTIONAL,
- REASSERT LEADERSHIP IN AN IMF CONTEXT, STRESS THE IMPORTANCE OF ARTICLE IV, AND PUT THE IMF BACK IN CENTER STAGE AS THE INTERNATIONAL LENDER OF LAST RESORT ("IT WOULD BE HEALTHY BALANCE TO EMS")

B. COUZENS SAW THE ABOVE AS MEETING THE NEED OF A U.S. INITIATIVE, BUT CONSIDERED U.S. ACTION STILL NECESSARY ON ENERGY TOO -- IF THE PRESIDENT COULD ANNOUNCE IT DURING HIS IMF SPEECH, IN THE CONTEXT OF "WE CAN'T WAIT ANY LONGER FOR CONGRESS", THEN SO MUCH THE BETTER.

C. IN RESPONSE TO TREASURY REP'S QUESTION OF WHAT U.S. SHOULD SAY AT IMF ABOUT EMS, COUZENS REPLIED "IT WILL GO ITS OWN WAY".

7. PLEASE TREAT ABOVE AS NOFORN. TREASURY REP TOLD COUZENS HE WOULD PASS LATTER'S VIEWS TO UNDER SECRETARY SOLOMON.

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## Message Attributes

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